

Behavioural Psychology and Investing

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Agenda

- Examples of highly irrational behaviour and biases
- Common Biases with examples
- Applications to Investing
 - How can Investors avoid common mistakes?

Myself

- Founder of:
 - Mints.pro - a blockchain based rewards & loyalty program
 - Neyberz.com - home cooked food sharing platform
- BTech. IIT, MBA (1st Rank) from XIM, Bhubaneswar
- Hobbies – Reading, investing and tech (blockchain/bitcoin).
- Tracking irrationality since 2008 - Influenced by Charlie Munger’s talk on “Psychology of Human Misjudgements”

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My Story

What this talk is **NOT**:

- ✘ From a professional psychologist or a behavioral expert
- ✘ A to-do checklist - it is more of a **don't-do** checklist!
- ✘ Loaded with technical jargon about psychology
- ✘ A get rich scheme to identify investment opportunities
- ✘ Pass judgement on any religious/political/social customs
- not trying to **judge** but to **understand**

We think we are rational?

Let's see some examples where people like us behave totally irrationally.

*Suicides Reported in India After
Death of Jayalalithaa Jayaram*

**After Jayalalithaa's
Death, Wave of Suicides
Grips Tamil Nadu**

**Tamil Nadu: 470
people died of shock
after Jayalalithaa's
death**



***Some set themselves ablaze, some
hanged themselves, while another
jumped before a speeding bus.***



**Gurmeet Ram Rahim
Singh convicted in 2002
rape case**

**2017: Dera violence toll
up to 36: HC slams
central and state govts**

**Despite rape charges,
people sent wives,
sisters, daughters to
Baba for blessing**



BBC:

A terrible mixture of fear, terror and apprehension about the future, mass hysteria and possibly genuine grief as well



ANI
@ANI

Following

[#KarnatakaElections2018](#): Rs 31.55 crore cash, 1.15 lakh litre liquor worth Rs 4.58 crore, 30.52 kg drugs/narcotics worth Rs 19.79 lakh, 14.492 kg gold worth Rs 3.59 crore and silver worth Rs 12.67 lakh seized by different agencies in various cars.

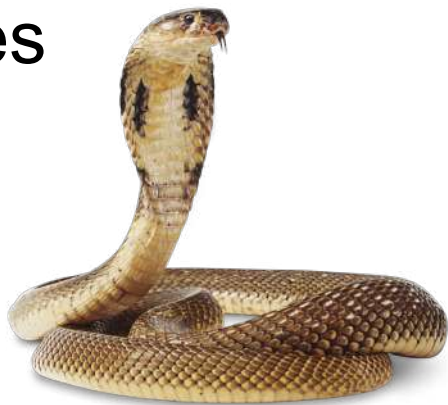
2:06 PM - 18 Apr 2018

**Cash for votes a
way of political
life in India**

Incentives

- People are very sensitive to rewards and punishment
 - **Never, ever, think about something** else when you should be thinking about the power of incentives
- Money is the basic incentive in life as it can be traded
 - However, people also change their behavior and cognition for recognition, sex, friendship, companionship, advancement in status and other non-monetary items
- Examples
 - Communism
 - YCombinator Equity Split
 - **Incentive Induced Bias**

Incentives



You must have the confidence to override people with more credentials than you whose cognition is impaired by incentive-caused bias or some similar psychological force that is obviously present. But there are also cases where you have to recognize that you have no wisdom to add - and that your best course is to trust some expert.

— *Charlie Munger* —

Ship Date



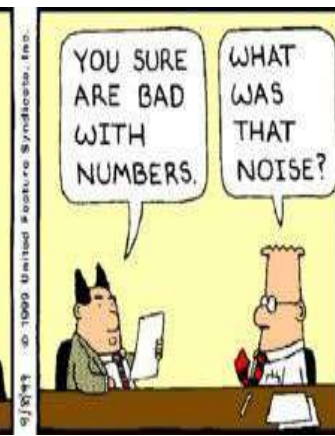
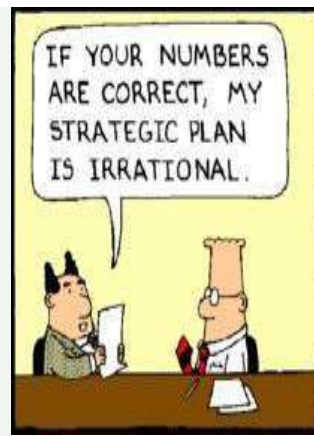
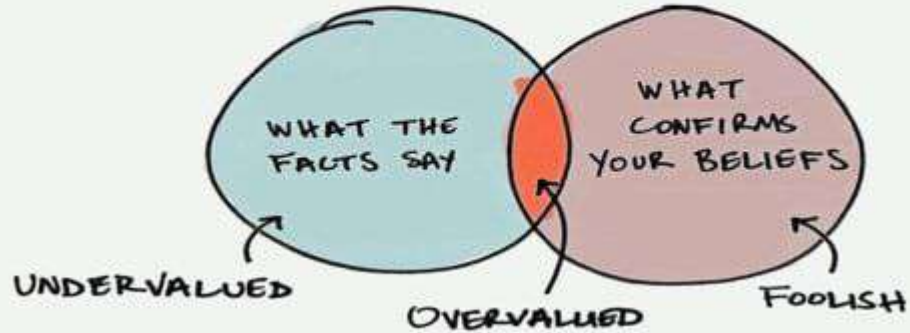
Bugs



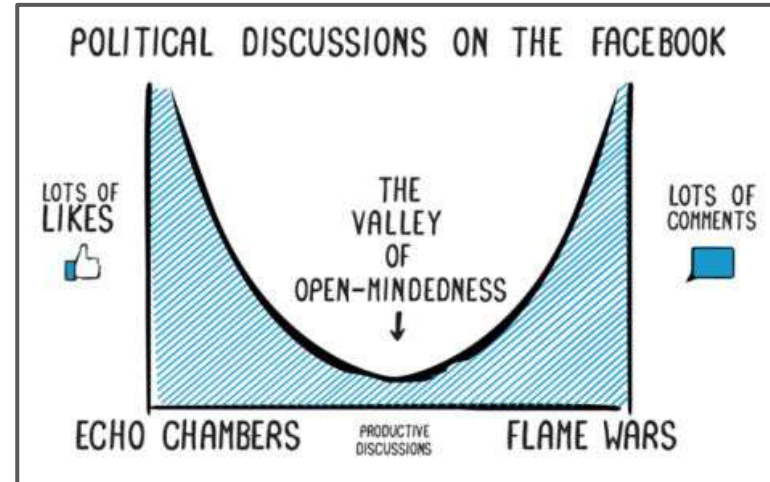
Confirmation Bias

- Anti-change tendency of the brain => one's previous conclusions, human loyalties, reputational identity, commitments.
- Much easier to prevent a habit than to change it.
- Judges are required to hear long and skillful presentations of evidence and argument from the side they will not naturally favor
- Devil's Advocate: Decision makers often force groups to consider skillful counter arguments before making decisions.
- Darwin's Prescription

CONFIRMATION BIAS



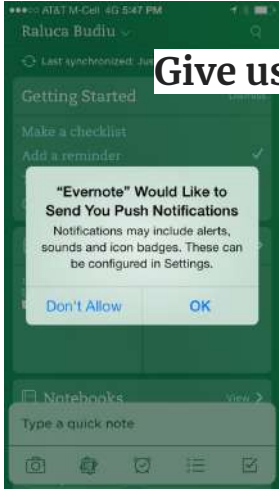
- Initiation Ceremonies
- Cults
- Complete the sentence:
 - X is the best candy...
- Public Commitments
- Flexible politicians (ex. Trump)
- Experts!



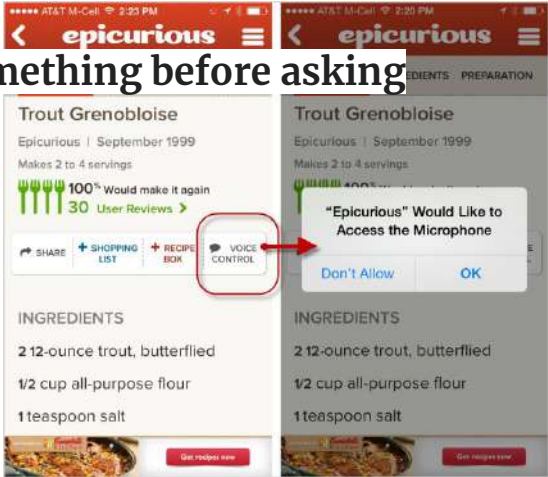
Reciprocation

- Comfortable shops and helpful salesmen leads to sense of reciprocation
- Tesla, Apple - admired not just for the products they make, but more so for the pain they are take for the customer. *Compare with Microsoft in its heyday.*
- Beneficial in ethical businesses as a compounding effect
- The reciprocity-based, religion-boosting idea of obtaining help from God in reciprocation for good human behavior has been vastly constructive.

Reciprocation Tendency



Give users something before asking



Doubt Avoidance (System 1)

- System 1 “is the brain’s fast, automatic, intuitive approach”
System 2 “the mind’s slower, analytical mode, where reason dominates.”
- Daniel Kahneman
- Faced with vast amounts of data and a shortage of time we opt for simplicity
- Examples:
 - Entrepreneurs are irrational optimists
 - Investing in bull runs
 - Trusting “instincts” in investments over “analysis” (boring/painful)

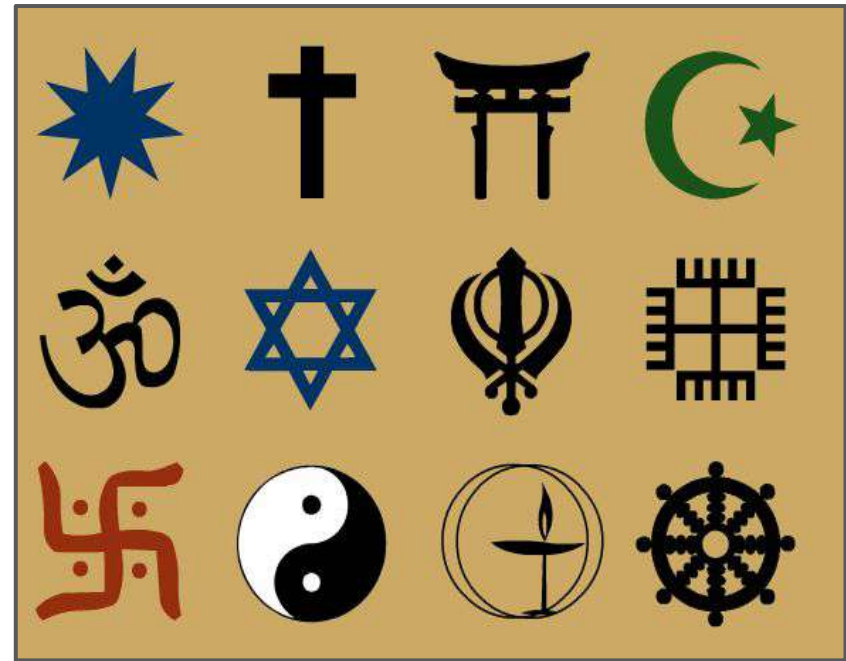
Doubt Avoidance (System 1)

Fill in the missing word

1. Red
2. Blue
3. Orange
4. Yellow
5. Gr _ _ _

Now fill in the missing word

1. Plum
2. Nectarine
3. Pear
4. Apple
5. Gr _ _ _



Puzzle, Stress => Religion

Decision Journal

Excessive Self Regard (Endowment)

- 90% of Swedish drivers that judge themselves to be above average.
- Most Criminals and Convicts feel:
 - I did not commit the crime - or -
 - My situation makes my crime forgivable and understandable
- We always disregard and forgive our past mistakes without objectivity
- “Fake it till you make it”

Excessive Self Regard (Endowment)



Dilbert.com DilbertCartoonist@gmail.com



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Deprivation Super-reaction (Loss Aversion)

- A man ordinarily reacts with irrational intensity to even a small loss, or threatened loss, of property, love, friendship, dominated territory, opportunity, status, or any other valued thing.
- Office politics over trivial estate
- All ideology is maintained with great antipathy to non believers - ex. Politicians on social media
- Sunk Costs or threatened losses
- Pivoting is hard for startups and businesses

Deprivation Super-reaction (Loss Aversion)

Scarcity



Figure 1. Example of a near-miss event in a slot machine.



Figure 2. Example of a complete-miss event in a slot machine.

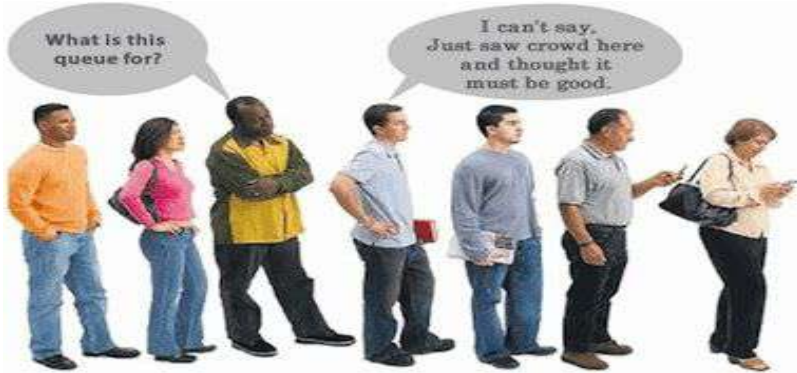
**Overweighting of what is near :
(someone worth \$10 million will
decrie losing \$100 out of \$300
from his wallet)**

**Pleasure of \$10 gain
<<
Pain of \$10 Loss**

Social Proof (Herd Mentality)

- Puzzlement and Stress
- Want to be liked and accepted
- Risks of standing out and being ridiculed
- social proof to help our friends avoid fear of flying, or driving
- Fanatic believers of a sect
- Most popular / Best-Selling on Amazon

Social Proof (Herd Mentality)



HOLLYWOOD LAUGH TRACKS

100 High Quality Laugh Tracks Available Now on iTunes and Amazon

Amazon Top Rated

Our best products based on customer reviews. Updated daily.

Any Category

- Appliances
- Arts, Crafts & Sewing
- Automotive
- Baby
- Beauty
- Camera & Photo
- Cell Phones & Accessories
- Clothing
- Computers & Accessories
- Electronics
- Grocery & Gourmet Food
- Health & Personal Care

See more Top Rated in

1.



Magnavox MPD820 8-inch Portable DVD Player by Magnavox

2.

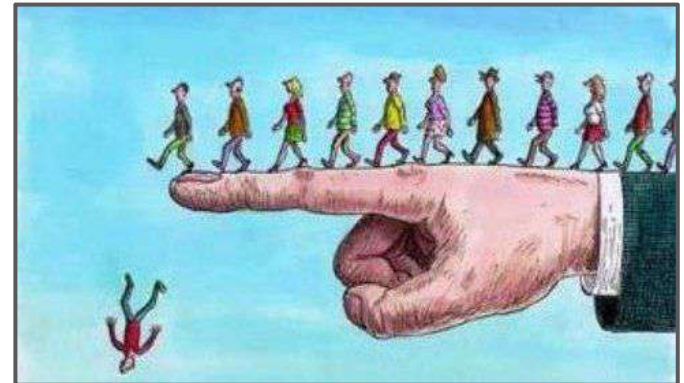


Yamaha DV05750 Progressive Scan DVD Player by Yamaha

3.



Magnavox MPD720 7-inch Portable DVD Player by Magnavox



Authority Mis-Influence

- Follow the leader
 - Has evolutionary basis for hunter gatherers
 - But leaders can be wrong - ex. Hitler
- Doctors or Professionals in advertisements
- Is the person really an expert?

Authority Mis-Influence



Anchoring Bias - Contrast Mis-reaction

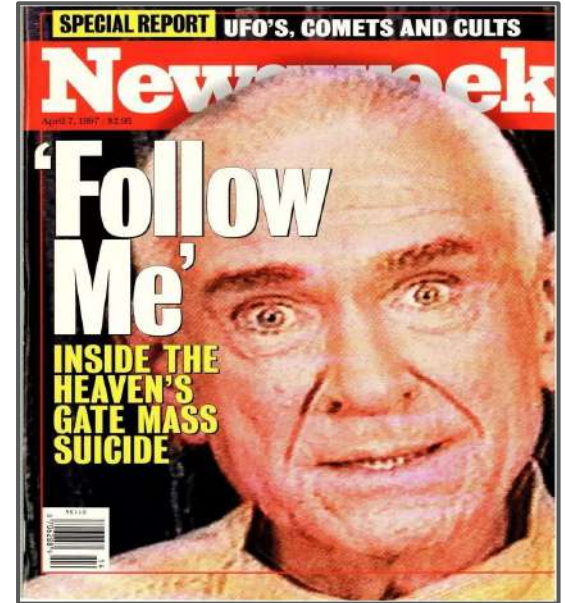
- Frog in hot water syndrome
- Rely too heavily on the first piece of information to make decisions
- Bad habits are easy to acquire step by step - ex. Weight gain!
- Examples:
 - Discounts over MRP in retail
 - Daily Petrol price revisions
 - High priced items on menu to trigger purchases

Anchoring Bias (Contrast Misreaction)



Economist.com	
SUBSCRIPTIONS	
OPINION	Welcome to
WORLD	The Economist Subscription Centre
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PEOPLE	<input type="checkbox"/> Economist.com subscription - US \$59.00
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	<input type="checkbox"/> Print subscription - US \$125.00
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	One-year subscription to the print edition of <i>The Economist</i> and online access to all articles from <i>The Economist</i> since 1997.

Lollapalooza



Applications

- Jayalalitha related Suicides :
 - **Social Proof** (Highly visible news about suicides results in an increase in suicide rates), **Deprivation Super-reaction** (loss of loved one), **Authority Mis-Influence** (Party seniors encouraging extreme steps)
- Ram Rahim :
 - **Doubt Avoidance** (Puzzle and Life Stress -> Religion), **Confirmation Bias** (Baba is pure, all others are liars), **Authority Mis-Influence** (All seniors advocate Baba's worship), **Social Proof** (All others are followers, so will I be one)
- Cash and Liquor for Elections :
 - **Reciprocation** (vote in return), **Social Proof** (all other candidates are offering and friends/family are taking money)

Applications to Investing

- **Power of Incentives:**

- Losses make people stop Investing
- Short term gains make you bullish
- Mis-selling due to *incentive induced bias*

- **Confirmation Bias:**

- Acting on believable rumours in markets
- Consuming news that is favorable to your investment idea - ex. Belief real estate will do well and then supported by research reports
- Disregarding evidence that conflicts with your investment philosophy

- **Reciprocation:**

- Positive reviews in lieu of favours for dud companies
- Free food and drinks in AGM - trick to not let too many uncomfortable questions in

Applications to Investing

- **Doubt Avoidance**

- How often do you trade on impulse without asking the right questions?
- How open are you to hear negative things about stocks that you are very optimistic about? The boredom and pain that is usually part of a thorough scrutiny and analysis of a stock is often avoided. Quick conclusions and quick decisions are often preferred instead of the burden of doubts and ambiguity.
- People are convinced that they have an advantage in investing over others!
- Investing in dud sectors you know about while missing good opportunities in other sectors

- **Endowment**

- Not being able to switch from one poorly performing asset to a better prospect
- Entering the market believing you are smarter than others
- False sense of accomplishment after a bull run

- **Deprivation Super-reaction - Loss Aversion**

- Not selling when price is lower than invested value

Applications to Investing

- **Authority Misinfluence:**

- Star Fund Managers
- Stock Tips from Market Experts

- **Social Proof (Herd Mentality):**

- Gold, Real Estate not in vogue in 2019
- Bull runs in stock markets - “wisdom of crowds”

- **Anchoring / Contrast Misreaction:**

- When stock prices fall, we start looking at the price they fell from (100 became 70) instead of looking at whether they are really worth the new price (70).
- Compound interest – the annual interests are small but they add up over time. Since the amounts are small, it is not easy to appreciate the factor time brings to investments or savings.

How can investors be careful?

- Take emotions out of investing - ex. SIP
- Try simple products like index funds (avoid **authority misinfluence**)
- Don't check your Portfolio daily (removes **loss aversion, anchoring bias**)
- Scarcity (**loss aversion**) is used as a trigger to urge to buy
 - Builders, IPO, NFO, Deals.....
 - Also prevents us from selling dead investments
- Understand **incentive induced bias** while buying financial products:
 - ULIPs/MFs are all sold by good people with these biases

How can investors be careful?

// Avoiding
Stupidity is Easier
than Seeking
Brilliance. //

fs

- **Try keeping a Decision Journal**

- Analyze your mistakes:

“I don’t revisit mistakes to bewail them, I revisit them for their learning purposes.” - Munger

- **Ask before making an investment:**

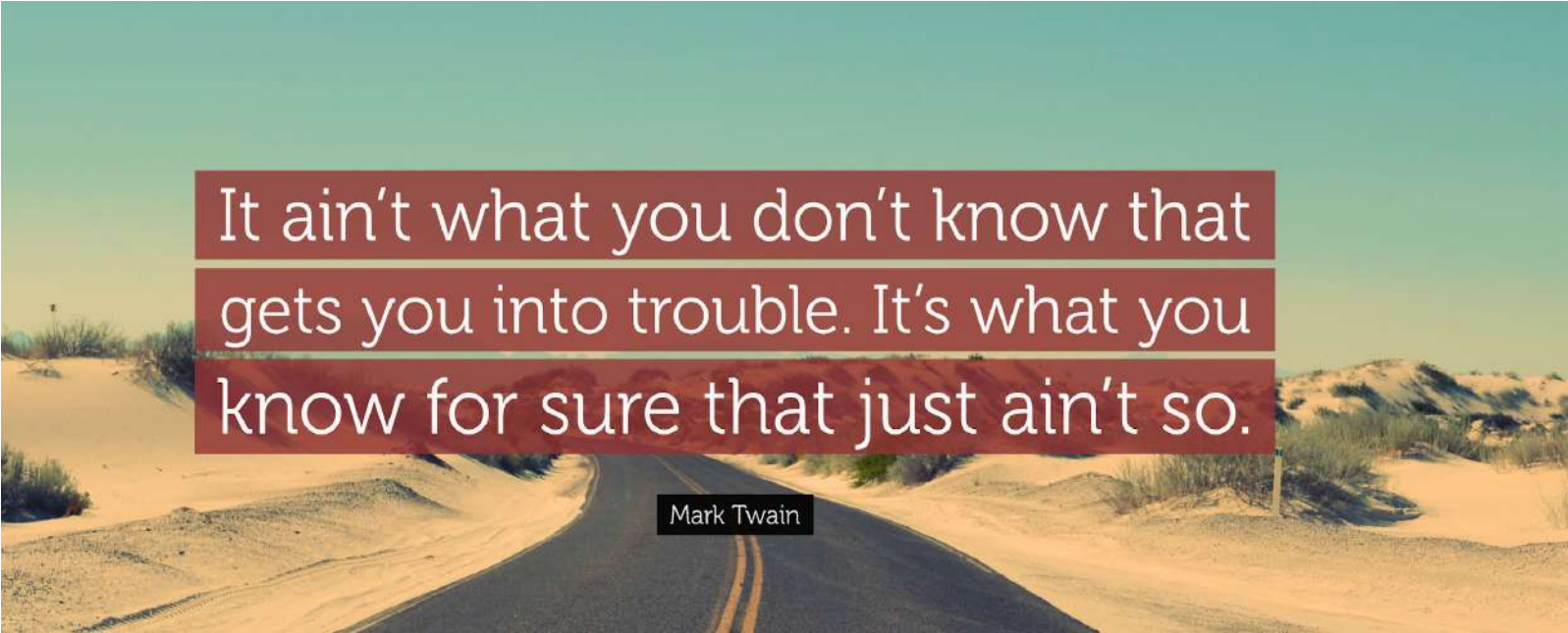
- What conditions or circumstances would it take for me to be proven wrong? If your answer is “none” or “that’s impossible,” you have a severe case of biases. The only cure for that might be the shock of losses that come at you like a bolt from the blue.

- Beware of **Lollapalooza**

- **Accept:** Making mistakes with your money - normal, human and hard to avoid!

Conclusion

- Evaluate extreme behaviour in *any* area you come across
- Beware of fixed ideas and beliefs
- Inversion
- Watch out for Lollapalooza

A photograph of a desert landscape with a winding asphalt road. The road has two yellow lines and curves through sand dunes and sparse desert vegetation. The sky is a clear, light blue. A large, semi-transparent dark red rectangular box is overlaid on the center of the image, containing a quote in white text.

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

Mark Twain

References

